UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

In re

COURTSIDE VILLAGE, LLC, No. 03-10105

Debtor(s).

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Memorandum re Plan Confirmation

I. Background

This case involves a 68-acre residential and commercial development project in Southwest Santa Rosa known as Courtside Village. The project has a long an convoluted history described accurately and in detail in the disclosure statement. The debtor has filed what it styles a liquidating plan of reorganization, but it is no such thing. The plan provides for the debtor to continue on as usual, run by the same management as before bankruptcy, but completely eliminating a class of small investors. The court finds that the plan is not fair as to the junior class and will therefore not confirm it.

The common thread in the long history of unrealized expectations associated with Courtside Village is Alan Strachan, who had no prior development experience or training.[1] He was a general partner of Countryside Racquets Club Development Limited, the originator of the project and 50% owner of the debtor. He was the manager of Courtside Village, LP, the first owner, and its successor,

[1]It is hard to believe, given the ultra-low interest rates in effect today and the huge run-up in property values in this county over the last decade, that any real property development conceived in 1991 could fail to make everyone associated with it rich. Strachan seems to have accomplished this feat.

debtor Courtside Village LLP. He is a consultant for Courtside Construction Company, which purchased the rights to part of the project from the debtor. Under the plan, Strachan is to manage the re-vested debtor.

The only parties prejudiced by the plan, and therefore the only objecting parties, are the so-called "soft note" holders of Class 3. The plan calls for business as usual by the debtor, with the unsecured creditors of Class 1 (many of whom are insiders) being paid in full and the Class 2 creditor, 50% owner Countryside Racquets Club Development, LLP recovering its capital contribution next. Anything left over (probably nothing) goes to the Class 3 creditors. The plan is silent as to the treatment of the equity interests of the debtor, no doubt because they don't care as they are being taken care of through payments to classes 1 and 2.

II. Subordination of the Class 3 Claims

Regardless of the form of the transaction, the "soft notes" are clearly junior securities as defined in § 101(49)(A) of the Bankruptcy Code. The Class 3 creditors are in essence landowners who, early in the project, gave the debtor's predecessor in interest options to purchase their real property at a price of $200,000.00 per acre.[2] Strachan was unable to raise the necessary capital for a development project at that price, so the landowners agreed to a new deal whereby they would receive $100,000.00 per acre in cash and a "soft note" for the balance. The notes provided that:

> Notwithstanding anything to the contrary in this promissory note, Payment of principal or interest shall be made only if and to the extent that Funds are available after (i) that certain promissory note from [the debtor] to Argonaut Constructors, Inc. . . . shall have been paid in full; and (ii) distributions could be made pursuant to California Corporations Code Section 17254 to each member of the Payor in an amount equal to the unreturned capital contributed by each such member to [the debtor].

[2]Some of the Class 3 creditors, the so-called "Stone Investor Group," have the same notes but acquired them in a different way. These creditors had made a bridge loan to the debtor and ended up in litigation over the loan. In settlement of the litigation, these creditors agreed to take "soft" notes like the landowners.

The notes were accompanied by a security agreement and considerable written disclosures regarding risks and clearly stating that before any payment is made on them the members of the debtor are entitled to be repaid their capital contributions and loans to the debtor with interest.

The Class 3 creditors argue that their property was worth $200,00.00 per acre, so that their agreement was nothing more than an acceptance of part of the purchase price in the form of a note. However, they offer no satisfactory explanation as to why they would agree to sell their land on term which clearly placed half of the "purchase price" behind the equity interests of the debtor. It is far more likely that their land was worth only slightly more than $100,000.00 per acre, so that the speculative possibility to recover up to $200,000.00 was worth more to them than the actual value of their land at the time.

The Class 3 creditors have staked out a litigation position that makes adjudication of the confirmability of the debtor's plan difficult for the court. Instead of addressing the workings and fundamental fairness of the plan, the Class 3 creditors are deep in denial of their situation and insist that they have the rights of unsecured creditors when that is contrary to the terms of the "notes" and the Bankruptcy Code.

Section 510(a) of the Bankruptcy Code makes subordination agreements enforceable in bankruptcy cases. The Class 3 creditors argue that "no true subordination of debt" was achieved by the notes because the notes provide for subordination to capital rather than debt. This is true, but only because, despite what they were called, the "soft notes" were actually "equity interest profit participations."[3] Thus, while the Class 3 creditors seek to escape the binding nature of § 510(a) they hop from that frying pan into the fire of § 510(b), which subordinates damages arising from the purchase or sale of securities. A note can be a security pursuant to § 101(49)(A)(i); rights under it may be

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[3]This term was used by counsel for the debtor in state court litigation prior to bankruptcy, and exception was not taken by counsel for the Class 3 creditors. The court finds it an accurate description of the true nature of the "soft notes." As a court of equity, this court looks to the substance of a transaction and not its form. *Pepper v. Litton*, 308 U.S. 295, 305 (1939).

subject to subordination under § 510(b). *In re Betacom of Phoenix, Inc.*, 240 F.3d 823, 832 (9th Cir. 2001).

The Class 3 creditors argue that their claims are not based on damages arising out of the purchase or sale of securities, but their logic is very flawed. It is based on the "security interest" they received along with their "soft notes." The security interest pledges as security the debtor's right to payment under the partnership, with several exceptions. It also defined "Partnership" to include all successors to the debtor. After the agreement, the debtor went through major restructuring, including the departure of a principal investor and the creation of Courtside Construction Company. The debtor and the Class 3 creditors disagree as to whether these machinations breached the security agreement.

The argument of the Class 3 creditors is that the notes provided that they became all due an payable upon a breach of the note or the security agreement; that the re-structuring of the partnership and the creation of Courtside Construction Company were breaches of the security agreement; and that as a result the notes became all due and payable and - *voila* - the soft note holders became general unsecured creditors. Unfortunately, their claims are not based on the notes themselves but on the breach of the agreement; they are accordingly barred by § 510(b) from becoming general unsecured creditors. Just because a right to damages arises out of breach of contract and not fraud does not mean that claims of securities holders are immune from subordination under § 510(b). *In re Betacom of Phoenix, Inc.*, 240 F.3d at 829. Any claims the Class 3 creditors have based on the alleged breach of the security agreement are of the same priority as the note, and do not serve to elevate their status.

Because of the Class 3 creditors' misplaced insistence that they can bootstrap themselves into the status of unsecured creditors, they have given short shrift to the real issue of the case, which is whether the plan is fair and equitable. This is the reason why the court will not confirm the plan.

III. Fair and Equitable

To call the debtor's plan a "plan of liquidation" is disingenuous. The debtor is continuing on in its business, just as before, and under the same management and control. The only thing the plan accomplishes is to rid the debtor's owners of the pretense of caring a whit about the Class 3 creditors.

Section 1129(b)(1) of the Bankruptcy Code provides that a plan should be confirmed only if it is fair and equitable to dissenting classes. At the heart of this situation, there is no doubt that the Class 3 creditors are not being treated fairly. The debtor had in essence agreed that the "soft note" holders would be paid as soon as a Argonaut Constructor was paid and its partner recouped its capital contribution, but subsequent machinations have allowed the debtor and its principals - notably Alan Strachan - to realize considerable value for themselves while pushing the "soft note" holders further and further behind the eight ball.[4] When a plan is proposed solely to favor insiders, it is not fair as to a dissenting class of non-insiders. *In re Woodbrook Assoc.*, 19 F.3d 312, 321 (7th Cir. 1994).

Under the plan, Strachan would reap yet another $5,000.00 per month. This is not fair. Contrary to assertions in the debtor's disclosure statement, liquidation under Chapter 7 is much fairer than the debtor's plan because a Chapter 7 trustee - who could hardly be less competent than Strachan - would be motivated to realize as much as possible for the estate and would not be interested in using the terms of the soft notes to funnel funds to the principals at the expense of the Class 3 creditors.[5]

A plan is not fair to a dissenting class of creditors if it allows a junior class to participate in any way in the reorganization. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202, 99 L.Ed.2d 169, 176 (1988). The debtor's plan violates this rule through its retention of management through Strachan and payment to Strachan and its silence as to the rights of the Class 4 creditors. Nor are these mere technical deficiencies which the debtor can easily cure; only turning the reins of control over to the Class

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[4]The security interest excludes management fees, which is one way Strachan has taken care of himself while the Class 3 creditors remained unpaid. While possibly not rising to the level of a breach of the agreement, it is hardly fair.

[5]This is not a case where many employees would lose their jobs or the economy of the county could be affected. Were that the case, the court might conclude that the plan should be confirmed even though the Class 3 creditors ended up losers. In this case, however, liquidation under Chapter 7 would benefit the Class 3 creditors - giving them at least the possibility of a recovery - and be of no detriment to anyone else.

3 creditors or liquidation under Chapter 7 would be fair.

IV. Conclusion

The Class 3 creditors are in fact junior equity interest holders; nothing they can do or say results in their elevation to the status of unsecured creditors. However, the plan is not fair as to them because the debtor's owners would maintain control of the debtor and the primary purpose of the plan is to benefit insiders. Accordingly, the plan will not be confirmed. A separate order will be entered.

Dated: October 29, 2003

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Alan Jaroslovsky
U.S. Bankruptcy Judge